

Climate Change – The Emerging Liability Risks for Directors and Officers Part 2



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Executive Summary

The ratification of the Kyoto Protocol should open up significant opportunities for businesses in the global carbon markets. In addition to the financial risks associated with carbon reduction and legal compliance costs implications, directors and officers should also consider the opportunities that might be available to them following the Kyoto ratification.

Directors of companies that have international operations or with significant international markets should also incorporate the various legal and regulatory developments overseas into their business plans.

Directors and officers need to ensure that they communicate clearly with their stakeholders so that there is a good understanding of the company's strategic policies in relation to climate change and the reasons for those policies.

In Part 2 of this Paper, we highlight some of the issues that directors and officers need to be aware of in relation to the management of climate change and related liability risks including the legal requirements that company directors and officers must be aware of as a matter of operational compliance.

In Part 3, we look at the management strategies directors and officers need to have in place in order to manage their liability risks and protect themselves from potential personal liability.

The Legal Landscape – Implications for Directors and Officers

In Part 1 of this White Paper Series, we identified how climate change risks are relevant to the decision-making processes of directors and officers. We discussed some of the business risks and opportunities that can flow from climate change risks and some of the pertinent issues that should be considered by all directors and officers from a good corporate governance perspective.

In Part 2 of this Paper, we shall highlight some of the legal requirements that company directors and officers must be aware of as a matter of operational compliance. What is the legal framework within which directors and officers must operate as far as climate change risks are concerned?

Our aim is not to give an exhaustive legal analysis of the regulatory requirements that relate to the issue of climate change. Rather, we seek to highlight some of the issues that directors and officers need to be aware of in relation to the management of climate change and related liability risks.

Legal Framework – At International Level

The Kyoto Protocol

The ratification of the Kyoto Protocol should open up significant opportunities for businesses in the global carbon markets. As a party to the Kyoto agreement, Australian businesses may now participate in emissions trading for the purposes of fulfilling their commitments under the Protocol. The aim is to ensure that the greenhouse gas emissions in Australia are not higher than 8 per cent above 1990 levels over the period from 2008 to 2012 (the Kyoto Target). Penalties may follow if Australia's emissions were to go above that level.

An emissions-trading scheme works by setting a target for emissions (such as the Kyoto Target) with a pricing mechanism to meet that target. Countries, such as Australia, that are parties to the Kyoto Protocol and who meet their emissions reduction targets are allowed to trade emission units generated through any surplus reductions on the international emission trading market.

But what should the ratification of the Kyoto Protocol mean to directors and officers of companies? Larger companies will most likely already have in place leading edge strategies on greenhouse gas emissions and ways in which to ensure their reduction. But not all companies are certain as to the precise impact of the Kyoto Protocol on their business operations.

The fact of the matter is that all businesses will need to consider how they can reduce their carbon emissions in their business operations. Australia as a whole must reduce the amount of greenhouse gas emissions in order to reach the Kyoto Target. The industries that will be most heavily affected by the Kyoto Protocol will likely to be those in the power generation, transport and manufacturing businesses and those in construction and agricultural materials. Operating costs would no doubt increase and, at the end of the day, those costs would be passed on by increases in the cost of electricity and a range of goods and services to both businesses and household consumers. These businesses will need to understand downstream implications and how to manage and mitigate risks.

In addition to the financial risks associated with carbon reduction and legal compliance costs implications, directors and officers should also consider the opportunities that might be available to them following the Kyoto ratification. For instance, can they avail themselves of some of the opportunities that are now available in the carbon emissions trading market? Can they invest in any projects that are aimed at carbon reduction?

Furthermore, directors of companies that have international operations or with significant international markets would also need to incorporate the various legal and regulatory developments overseas into their business plans. These businesses would need to bear in mind, for instance, the Emission Trading Schemes in the United Kingdom, Europe and also in many States in the United States of America.

Legal Framework – At Federal Level

The National Greenhouse and Energy Reporting Act 2007 (Cth)

At the Australian Federal level, directors and officers of companies must understand their reporting obligations under the National Greenhouse and Energy Reporting Act 2007 (the NGER Act). This Act commenced operation on 1 July 2008 and the first reporting requirements are due for the 2008/2009 financial year.

The NGER Act is a national reporting framework for the reporting of greenhouse gas emissions, energy use and energy production. It is intended to underpin the introduction of a national emissions trading scheme (see discussion below). The Act requires all “controlling corporations” to register and report on behalf of their group of companies whether their greenhouse gas emissions, energy production or energy consumption were above certain thresholds.

There are two levels of thresholds at which corporations are required to apply for registration and report—facility thresholds and corporate thresholds. When a controlling corporation’s group meets a facility or corporate threshold, the controlling corporation must apply for registration and report its greenhouse gas emissions and energy data to the Greenhouse and Energy Data Officer at the Department of Climate Change.

A key feature of this Act lies in its enforcement provisions. It imposes, in certain circumstances, civil penalties on the Chief Executive Officers (CEO) of corporations for non-compliance with this Act. Under the Act, the CEO will be liable for all breaches for which the corporation has civil liability if:

- the CEO either had knowledge of the contravention, or was reckless or negligent as to whether the contravention would take place;
- the CEO was in a position to influence the conduct in question, and
- the CEO failed to take all “reasonable steps” to prevent the contravention.

If the CEO is found to be in breach of the Act, he or she may be ordered to pay a penalty equal to that which the court could impose on the corporation for contravening the provision in question. With penalties of up to \$220,000 and additional overdue daily penalties plus criminal charges for executive officers found to be in breach, the cost of non-compliance is significant.

The pressure is therefore clearly placed on the shoulders of CEOs and other executive officers of companies to ensure compliance with this Act.

In fact, directors and officers need to be very careful not only from a compliance standpoint - they also need to be mindful of potential actions from investors who rely on their “greenhouse” reporting. Suppose, for instance, a company’s reporting on their greenhouse gas emissions, energy use and energy production statements are shown to be incorrect. This may result in the company’s shares being sold by, for example, managed funds that invest in businesses with a sustainable and socially responsible corporate governance focus. A consequential drop in shareholder value might be perceived to be a potential cause for future claims by shareholders against the directors and officers. An action might be based, for instance, on the misleading and deceptive conduct provision of the Trade Practices Act, 1974 (Cth).

From a personal liability perspective, proper and careful reporting is obviously an issue that all directors and officers must have at the forefront of their minds.

The Corporations Act 2001 (Cth)

In addition to the NGER Act, directors and officers also need to be aware of their reporting obligations under the Corporations Act 2001 (“the Act”). Whilst there is no specific obligation under the Act for companies to report on climate change risks or performance, there are general reporting obligations.

For instance, sections 295 to 297 of the Act require disclosure of environmental information in the company’s financial report to the effect that it affects the company’s financial position and performance.

Similarly, directors and officers should note section 299 of the Act in relation to disclosure of general information about the operations and activities in a company’s directors’ report. This section provides that, where any entity’s operations are subject to “any particular and significant” environmental regulation under a law of the Commonwealth or of a State or Territory, the director’s report must give details of the entity’s performance in relation to environmental regulation.

Whilst the Act does not provide specific guidance on what precisely must be disclosed under section 299, the Australian Securities and Investment Commission (ASIC) has indicated, amongst other things, that the requirements are not related to financial disclosures but, rather, to performance in relation to environmental regulation. The information in the directors’ report can be more general (and therefore less technical) than that contained in other compliance reports to an environmental regulator.

Clearly, companies need to be conscious of their disclosure requirements under the Corporations Act and the directors’ report may therefore include information disclosed under the NGER Act.

Carbon Reduction Pollution Scheme

The Australian Government has sought to legislate for a national Carbon Reduction Pollution Scheme. It intends for the scheme to commence operation by 2011.

The intention is to establish an Australian Climate Change Regulatory Authority which will regulate the effective operation of the scheme. For the first time, the cost of carbon pollution would be factored into all decisions in the Australian economy. Furthermore, the scheme is designed so that Australia can meet its reduction targets in a flexible and cost-effective way.

The scheme would, undoubtedly, affect the way businesses operate but how and whether precisely that will be the case remains to be seen. At the time of writing, the legislation has, however, met with contrary and strong opposition in Parliament.

The Renewable Energy (Electricity) Act 2000 (Cth)

It is worth bearing in mind that, even before the official ratification of the Kyoto Protocol in 2007, the previous Howard Government had enacted, at a federal level, the Renewable Energy (Electricity) Act 2000 (Cth) with a view to increasing renewable electricity generation from Australia’s renewable energy sources. The plan was to encourage the generation of an additional 9,500 gigawatt hours of renewable energy per year by the year 2010. Wholesale purchasers and large individual users of electricity have been encouraged to purchase additional amounts of electricity from “accredited” renewable sources such as solar, wind, photovoltaic, hydro and biomass.

Under this Act, electricity purchasers and users are able to create a form of transferrable intangible property known as ‘Renewable Energy Certificates’ (RECs) in order to meet their legislative obligation. If, for example, an electricity retailer purchases wholesale electricity in order to meet their retail sale obligations to customers, then they are directly responsible for supporting an increase in the amount of electricity generated from renewable energy sources. This is implemented through the surrender of RECs in proportion to their acquisition of electricity.

The penalty for failing to comply with this scheme is the payment of \$40 per tonne of carbon emission.

Legal Framework – At State Level

There are, at present, various State based initiatives that have been put into place in recent years by the State governments in response to the climate change risks.

In Victoria, for instance, the Renewable Energy Target Scheme commenced operation on 1 January 2007 and requires Victoria's consumption of electricity generated from renewable sources to be increased to 10% by 2016. The aim of this scheme is to encourage additional generation of electricity from renewable sources.

In New South Wales, the NSW Greenhouse Gas Reduction Scheme commenced operation on 1 January 2003. The aim of this scheme is to reduce greenhouse gas emissions associated with the production and use of electricity. It achieves this by using project-based activities to offset the production of greenhouse gas emissions.

Furthermore, the NSW Government has recently announced, on 27 February 2009, the introduction of an Energy Savings Scheme intended to build on the energy efficiency achievements of the Greenhouse Gas Reduction Scheme. This scheme commenced operation on 1 July 2009 and will continue until 2020 unless it is replaced by a national scheme.

Meanwhile, South Australia has enacted the Climate Change and Greenhouse Emissions Reduction Act 2007 (SA) which became law on 3 July 2007. This Act sets out three targets:

1. to reduce, by 31 December 2050, greenhouse gas emissions within the State by at least 60 per cent to an amount that is equal to or less than 40% of the 1990 level – as part of a national and international response to climate change;
2. to increase the proportion of renewable electricity generated so as to comprise at least 20 per cent of electricity generated in the State by 31 December, 2014, and
3. to increase the proportion of renewable electricity consumed so that it comprises at least 20 per cent of electricity consumed in the State by 31 December 2014.

The legislation also commits the South Australian government to work with business and the community to develop and put in place strategies that will put South Australia in a position to take early action to reduce greenhouse emissions and adapt to climate change.

Directors' and Officers' Liability and The Business Judgment Rule

With the proposed introduction of a national Carbon Reduction Pollution Scheme that is aimed to support the global response to climate change and the operation of various State based initiatives that are currently in place, together with the regulatory reporting and disclosure requirements that are placed on companies in relation to climate change risks, directors and officers have to be mindful of their compliance obligations.

But apart from the issue of compliance, directors and officers have statutory duties to act in the best interests of their company and with reasonable care and due diligence. A failure to do so is an offence under the Corporations Act for which directors and officers may be personally liable.

One of the major duties of a director is to protect the assets of the company (and thus, ultimately, the assets of shareholders) and to address effectively the risks and opportunities underlying the company's business operations. Most companies nowadays would most likely have in place internal management guidelines and policies to determine if and how their business activities may negatively affect the environment. However, that is only one aspect of assessing climate risk within the business.

The reality is that concerns brought about by climate change are creating a whole new category of business risk and opportunities for company directors and officers – as discussed in Part 1 of this White Paper Series - that must be carefully managed otherwise they may face potential liability for failing to act with due care and skill and in the best interest of the company.

In the event that a legal action is brought against directors or officers for failing to discharge their statutory duty to act in the best interest of the company, the directors or officers may be able to invoke the operation of the “business judgment rule”. Under this rule, directors can defend their action by saying that they have discharged their duties to the company by having made an objective judgment, in good faith, that they rationally believed was in the best interest of the company. In short, this rule offers directors a “safe harbour” from personal liability for breaches of the duty of care and diligence in relation to honest, informed and rational business judgments.

The rationale of the “business judgment rule” is to promote optimal corporate governance without compromising on directors' flexibility and innovation. In this day and age where the issue of climate change and its effect on the global economy is a serious issue discussed at board level and where information in relation to climate change and its associated risks are widely accessible, it is crucial for directors and officers to show that they have made proper “business judgments” in relation to their decisions which are related to climate change risks and opportunities.

For example, if directors and officers of a company do not obtain adequate information about climate change and fail to take appropriate steps to mitigate the risks or maximise the opportunities available to the company, they might potentially be in breach of their duty of care and diligence owed to the company. In failing to make informed decisions in good faith, the “business judgment rule” may not excuse their actions or inaction in an allegation of a breach of duty.

Furthermore, in this current political and litigious climate, clear and effective communication is crucial between the company and its stakeholders. Directors and officers need to ensure that they communicate clearly with their shareholders, investors, employees etc so that there is a good understanding of the company's strategic policies in relation to climate change and the reasons for those policies.

Having identified some of the legal implications for directors and officers in relation to climate change, we need to ask: what sort of management strategies do directors and officers need to have in place in order to manage their liability risks? What exactly should they be doing in order to protect themselves from potential personal liability? This issue will be discussed in Part 3 of this Liberty White Paper Series on Climate Change and Emerging Liability Risks for Directors and Officers.

The Liberty White Paper Series

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